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SUBJECT: SRI LANKA: LACK OF DESIRE FOR PEACE MAY IMPEDE ECONOMIC GROWTH

11. (SBU) Summary: The Ambassador met with a group of key financial sector institution heads on November 27. The meeting provided for a frank discussion on pressing issues faced by the sector and the country. While peace is essential for their business and for the economy, the group expressed grave concern over increasing support for war. They highlighted other key issues such as increasing and inconsistent taxation, and corruption. The group agreed to the Ambassador's suggestion that American Chamber of Commerce collect their thoughts into a paper presenting "The Business Case for Peace" that the Ambassador would share with senior Government of Sri Lanka leaders at the press. End Summary

12. (U) The Ambassador met with heads of key financial sector institutions on November 27. The meeting organized by the American Chamber of Commerce of Sri Lanka provided for a frank discussion on pressing issues faced by the sector and the country. The group included representatives of local and foreign banks, an insurance company, a BPO providing high end corporate research, an accounting company and a business consultancy firm.

Peace is the key to greater economic growth; desire for peace is the obstacle

13. (SBU) Participants identified the need for peace as the most important key to improving the investment climate, and expressed concern over rising support for war in the south as well as the north. Large sections on both sides of the country, from the political leaders to villagers expect to win the war. The villagers also favor war as it has provided lucrative employment to unemployed youth and fathers. Further, the 7 percent economic growth in 2006-2007 has also made them complacent about war. As a result, the negative consequences of war, including the economic ones, seem to have eluded the minds of some politicians and a part of the public. The financial leaders stressed the importance of educating the politicians and public at large on the "money case," i.e. monetary/economic benefits that could accrue from peace, including defense savings, foreign direct investment, and the possibility of attracting Sri Lankan expatriates abroad for the development of the country. The Ambassador volunteered to take the message to the political leadership, and requested the group to provide a paper outlining quantifiable benefits of peace under the title "The Business Case for Peace."

Increase taxes for the few who comply with the tax laws

14. (U) In addition to peace, the group raised several issues faced by the sector. Key among them was increasing and inconsistent taxation. For example, banking sector taxation exceeds 60% of profits, one of the highest rates in Asia. Insurance also faces high taxes. Insurance also faces high taxes. The tax liability for these sectors was raised again in the recently-passed 2007 Budget. In addition, taxation tends to be retroactive, subjecting businesses to liability for business decisions made in the past, making appropriately-developed business plans unsustainable. According to one financial leader, in the absence of other avenues of taxation and huge budget deficits, the government has resorted to regularly raising tax on four key "profitable" service industries: banking, insurance, telecom and shipping. Further, Sri Lanka's tax base has been eroded due to various tax incentives granted to investors. With the absence of political will to reform taxation and the tax administration, profitable sectors have become an easy prey.

Other impediments to greater economic growth

15. (U) The group also referred to the absence of a corporate bond market. Sri Lanka does not have pension funds that could invest in corporate bonds. Sri Lanka's main pension funds (which collect contributions from private sector workers and employers) are huge and controlled by the government which invests these funds into government securities. The government has no appetite for liberalization of these funds as they have become captive sources

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for deficit financing at negative after-inflation rates.

16. (U) Other impediments to development were:
- The monopoly extended to state owned banks over government business.
- Single borrower limits on lending to conglomerates/groups
- The need for deepening the capital market
- Corruption in government

17. (SBU) COMMENT: While the American Chamber of Commerce sector teas provide the Embassy with insights into the views of various business sectors, they also provide an opportunity for these sectors to discuss issues amongst themselves. One of the most alarming viewpoints that came out of this meeting was that the people from Sri Lanka's south (including the President's main constituency) think they stand to primarily benefit from continued conflict and, along with the fact that true peace has not visited this country for decades, business leaders doubt that there is any true desire to achieve peace. Meanwhile, the economy will continue to grow at a moderate pace because of continued strong remittances from abroad, good rains that assure a good agricultural year for the President's base of support, and good export performances. People will consider the status quo to be mildly acceptable.

BLAKE